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In UCLA $700M Sex Abuse Settlements, IRS Should Not Share

The University of California agreed to another round of settlements of sex abuse claims from hundreds of patients of former UCLA gynecologist-oncologist James Heaps, bringing the total settlements to nearly $700 million. The latest settlements total $374.4 million and resolve lawsuits that 312 women filed in state court. Previously, the UC Board of Regents agreed to pay $241.2 million to settle claims from 201 women. Most people would probably agree that such payments *should* not be taxed, but the tax law is hardly crystal clear on the point. That leaves plaintiffs receiving money in the uneasy position of having to decide whether to pay tax, disclose the settlement but not pay tax, etc. And how many years are they at risk from the IRS? Many claimants worry over the tax rules, and even talking with tax lawyers and accountants can be upsetting.

You do not want to pay tax if you don't have to, but you also don't want to face claims by the IRS or state tax authorities several years later with interest and penalties. How lawsuit settlements are taxed is surprising and complex. Under the tax code, compensatory damages for personal physical injuries or physical sickness are tax free. In contrast, damages for emotional injuries are fully taxable. Yet if you have emotional injuries *triggered* by physical ones, the damages for the emotional injuries are *also* tax-free. It's confusing, making taxing emotional distress and physical sickness a kind of chicken and egg issue. Adding to the confusion, exactly what is 'physical' is not defined. The IRS generally likes to see observable bodily harm such as bruises, cuts or broken bones. Yet many injuries are not as obvious but can be worse and take much longer to heal.

Where does sexual abuse or sexual assault stand in this equation? Clergy sex abuse, athlete sex abuse, scouting sex abuse and in other contexts, lawsuit settlements for abuse are numbingly familiar. Sadly, for many victims, an award of cash comes with tax worries too, adding more anxiety to the victim's experience. Despite all the years of abuse cases, the IRS has issued only one piece of guidance, and it is expressly non-precedential. It says that a clergy sex abuse settlement was tax-free even though the abuse occurred years before, and even though only emotional injuries could be shown. But there were some key conditions and limitations.

The IRS *assumed* that some of it was physical enough at the time to trigger the continuing emotional injuries years later. The IRS allowed the exclusion without proof of physical harm, but it's not clear if part of the IRS rationale was that the victim was a minor and many years had elapsed between the abuse and the settlement. If you are sexually assaulted or abused, you may not have obvious outward signs like bruises. But keep whatever evidence you have, including photos, doctor reports, police reports, and more. Some victims end up with PTSD, ant there are good arguments that PTSD is itself physical. Although former President Obama seemed to agree, the tax code so far does not say.

Tax advice before signing a settlement agreement can help, or even earlier when mediating a dispute. The IRS isn't bound by the parties' tax characterization, but the IRS often respects settlement agreement wording. The IRS rules on how lawsuit settlements are taxed can be confusing and seem unfair. Incredibly, in some cases now, legal fees can't be deducted. That can mean paying tax on 100%, even if 40% off the top goes to your lawyer. If you have that bizarre situation, check out 12 ways to deduct legal fees under new tax law.

In the case of sex abuse, the law should be clarified to make clear that these recoveries will not be taxed. The American Association of Settlement Consultants is mounting an effort to expand the tax law to *expressly* include sexual assault, sex abuse, molestation, and post traumatic stress disorder (PTSD) in the tax-free category. The IRS could perhaps make this kind of interpretive change itself, but some say the statute itself should be amended, section 104 of the tax code.

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